

## Strategy Matters

Issue 2008 - 11

### Will the second half of 2008 be any better than the first half?

#### A terrible first half to 2008

The first half of 2008 was an awful one for financial markets. Equity values plunged. The Morgan Stanley Capital International (MSCI) All-Country World index fell by 14% in local currency terms. All major equity markets recorded double-digit falls. Bonds fared a little better but returns were poor. Although 10-year yields in the United States were little changed during the first six months of the year, yields rose in Europe, the UK and Japan.

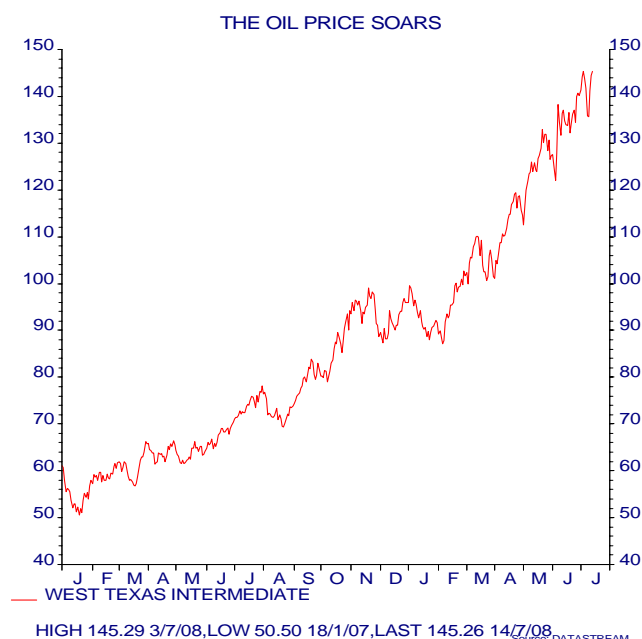
There were a number of reasons for this terrible performance.

First, more losses emerged in the financial system as a result of the collapse of the US sub-prime mortgage market. The US investment bank Bear Stearns had to be rescued, in a move orchestrated by the Federal Reserve, by JP Morgan.

Second, soaring food and oil prices pushed inflation rates to levels not seen since 1999. In some countries, this led to an increase in interest rates. In others, expected interest rate cuts became less certain.

Third, global economic growth slowed and leading indicators, such as business and consumer confidence, suggested that it would weaken further in the second half of the year. As a result, expectations of corporate earnings were cut.

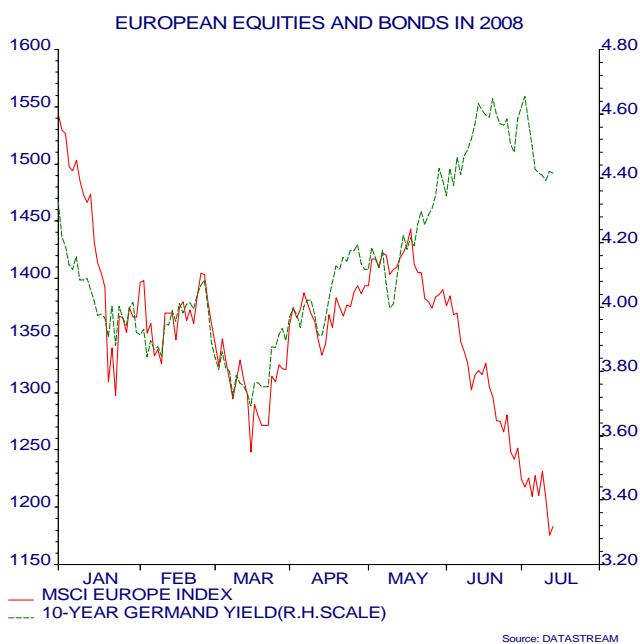
Higher oil prices contributed to the deteriorating growth and inflation outlook. Over the first six months of the year, the oil price increased by 46%.



#### Second half of 2008 – not much better so far

Showing no respect for the calendar, the second half of the year has continued in much the same vein as the first half. The oil price has risen to new record highs around \$145 a barrel, there has been a scare about the financial health of the US's two large mortgage agencies – Fannie Mae and Freddie Mac - and equity markets have already fallen by 5% or more in the first two weeks of July. The only good news is that bond markets have been stronger, with prices rising and yields falling.

It appears that financial markets are now more worried about the outlook for economic growth in the second half of the year, and in 2009, than they are about the short-term outlook for inflation.



### Will the rest of 2008 be any better?

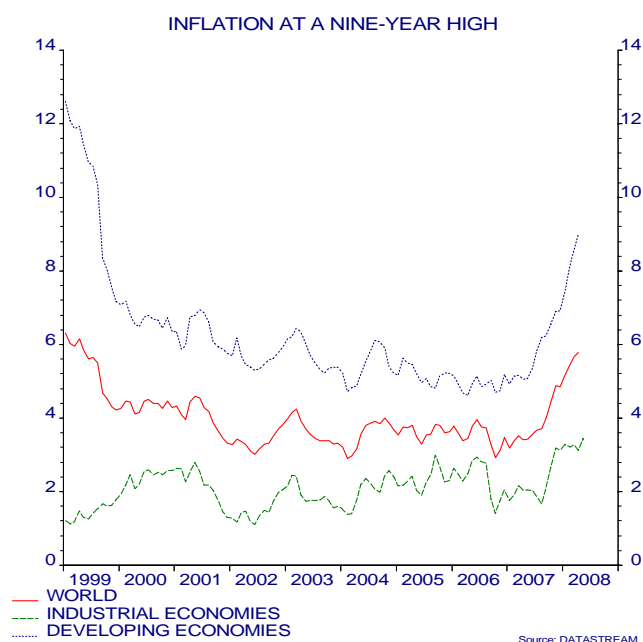
It is easy to be pessimistic about the rest of 2008.

It is unlikely that we have yet heard all the bad news that is to come out of the financial sector. More losses related to the US housing market are likely to be reported. Some smaller banks in the United States could close down. And there may need to be more action from the Federal Reserve and the European Central Bank to stabilise matters.

Meanwhile, global inflation, which is already close to 6%, will climb even higher. In the Euro-zone and the United Kingdom a peak rate close to 5% is expected in September or October. In the United States inflation could reach a high point above 6%.

If oil and food prices stop rising, then the inflation news should improve, gradually, from the fourth quarter onwards. However, forecasters have been assuming that oil and food prices will stop increasing for some time, and there is no sign yet of it happening. Primarily, this is because demand growth in emerging economies remains strong and supply is unable to cope. Only when emerging economies slow down, which may not be until 2009, will inflation fears start to ease.

In the meantime, there is a risk that inflation becomes entrenched. This would happen if workers look for larger wage settlements to compensate for higher food and energy prices and businesses grant higher settlements and pass the costs on in the form of higher prices. So far, there is no sign that this is happening, but the longer recorded inflation stays high, the bigger the risk. It is fair to assume that central banks would respond to larger wage settlements by raising interest rates, so increasing the chances of a recession in 2009.

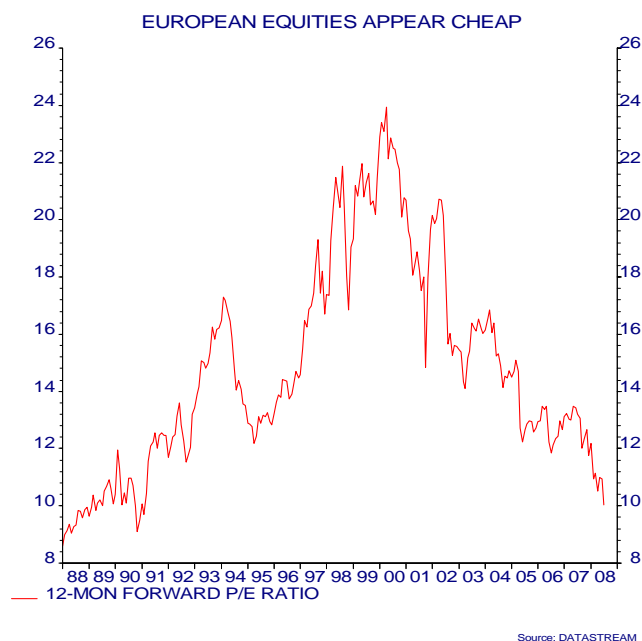


The global economy, and the European economy in particular, could come close to recession in 2009 in any case. Leading indicators already point to a period of very weak output growth. High interest rates, the strength of the euro, slower overseas demand and high oil prices are all likely to prove significant headwinds to growth over the next year or so.

High inflation and weak growth – called stagflation by some – is the worst combination for equity markets. However, it is not that unusual. In a normal economic cycle, inflation lags real economic activity. As a result, there is usually a phase when output growth has slowed but inflation is still rising, reflecting an earlier period of strong output growth. This is the phase of the cycle that we are in right now.

If this is a normal cycle, inflation pressures will ease in 2009 and central banks will be able to relax monetary policy. This should lift some of the pressure on equity markets.

There may then be scope for equity markets to rise. One factor that could boost them is valuation. On standard measures used in financial markets, like the price/earnings ratio based on analysts' estimates of where earnings will be in 12-months time, equity markets already look cheap. The worry is that, while the economic situation is deteriorating, earnings estimates will be cut, so markets may not be as cheap as they seem. However, once the economic picture appears to be improving, earnings estimates should start to be revised up. In that environment, valuation should underpin gains in equity prices.



Unfortunately, that is not likely to be until later this year, and perhaps not until 2009. In the next few months, worries about inflation, economic growth and the financial system are likely to dominate. This is not good news for equities.

## Conclusion

Financial markets in the first half of the year were hit by a 'perfect storm' of bad news: troubles in the financial system, slowing economic growth, downgrades to corporate earnings, higher inflation and the prospect of rising interest rates.

In the next few months, the news flow is unlikely to improve much, if at all. So financial markets are likely to remain volatile and there is a risk of new lows for equity prices.

However, the bear market is already advanced and equity markets appear cheap. If this is a normal cycle, inflation fears should ease towards the end of the year, creating scope for interest rates in Europe to come down in 2009 and setting the scene for a revival in economic growth. At some point, equity markets should recover in anticipation of such an outcome.

The second half of the year will not be easy for investors, but it could turn out to be less bad than the first half.

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